

Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements

CAP1769

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About this document

This document follows on from our consultations on the regulatory framework to support capacity expansion at Heathrow airport in June and December 2017 and April and October 2018.¹ It consults specifically on our initial proposals for the interim arrangements to apply after the end of the Q6 price control (in December 2019) for 2020 and 2021. In particular it examines the commercial arrangements for this period that have been agreed by Heathrow Airport Limited (“HAL”) and certain airlines and assesses whether these provide appropriate protection for the interests of consumers.

Views invited

We welcome views on all the issues raised in this document, particularly those set out in the executive summary and chapter 1.

Please e-mail responses to economicregulation@caa.co.uk by no later than 23 April 2019. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate appendix. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Elly Shafran (elly.shafran@caa.co.uk).

¹ See:

- See CAP1541 Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow www.caa.co.uk/CAP1541 (“the June 2017 Consultation”)
- Economic regulation of capacity expansion at Heathrow: Policy update and consultation www.caa.co.uk/CAP1610 (“the December 2017 Consultation”)
- Economic regulation of capacity expansion at Heathrow: policy update and consultation www.caa.co.uk/CAP1658 (“the April 2018 Consultation”)
- Economic regulation of capacity expansion at Heathrow: policy update and consultation www.caa.co.uk/CAP1722 (“the October 2018 Consultation”)

Executive summary

Introduction

1. The current price control on HAL's charges to airlines at Heathrow airport is due to expire on 31 December 2019. This control ("the Q6 price control") had been due to end in 2018 but was extended by one year.
2. In our April 2018 Consultation, we proposed a further two year extension to the Q6 price control to 31 December 2021 and called this further extension the "interim H7" (or "iH7") price control. We said the purpose of the iH7 price control would be to protect the interests of consumers by aligning the next main price control period ("H7") with the wider capacity expansion programme at Heathrow airport.
3. The capacity expansion programme at Heathrow airport will be a very large privately financed infrastructure project. Broadly aligning the timetable for the price control with the wider programme should allow for the development of regulatory incentives to promote capital and financial efficiency, so promoting overall efficiency and protecting the interests of consumers. This remains an important objective and the commercial arrangements for the iH7 period, that have been discussed by HAL and airlines, are also consistent with the broad alignment of the next price control review with the wider programme for capacity expansion.
4. For the iH7 price control, we proposed that the existing path for HAL's prices² continue at RPI-1.5% for 2020 and 2021 (subject to a financeability test for this second year). The benefits of any expected outperformance would be shared with airlines and consumers in the longer term by adjusting regulatory depreciation (and so HAL's regulatory asset base (RAB)) by an amount representing the difference between (i) the RPI-1.5% price path and (ii) underlying revenue allowances calculated by reference to our updated building block assumptions.³
5. The iH7 regulatory price review (the process by which we would estimate the underlying revenue allowances used to set HAL's price control) started in October 2018, when HAL submitted a short business plan for the 2019-2021

² The price control that the CAA sets for HAL is for a "maximum revenue yield per passenger", but for simplicity we use the expressions "prices" and "price path" in this document.

³ The regulatory building blocks are forecasts of passenger demand, opex, non-aeronautical revenues and capex.

period.⁴ This provided stakeholders with HAL's views on the assumptions, estimates and projections that it considers should be applied for each of the key revenue drivers or regulatory building blocks in 2020 and 2021. At the same time, to inform our review, we commissioned Cambridge Economic Policy Associates (CEPA) to undertake an independent assessment of HAL's submission and provide its own projections for the key regulatory building blocks, providing an alternative underlying price path.

6. In parallel, HAL and some of the major airlines operating at Heathrow have been negotiating a commercial pricing arrangement for the iH7 period to replace the CAA led price control review process.
7. The commercial arrangements now agreed between HAL and these airlines provide for:
 - a 'fixed' rebate to all airlines currently operating from Heathrow totalling £260 million, split into two equal payments of £130 million to cover 2020 and 2021;
 - payment of the fixed rebate would be spread over a four year period, a year after the rebate was accrued;⁵
 - a further volume rebate relating to the number of passengers if they rise above certain thresholds in 2020 and 2021, which would be paid in 2021 and 2022 respectively;
 - if passenger numbers were to turn out significantly lower than expected, then the arrangements also provide some downside protection for HAL, and in these circumstances the fixed rebate can be reduced; and
 - default arrangements for any airlines that chose not to agree to the commercial deal, we understand that these default arrangements would involve the airlines receiving an appropriate share of the fixed rebate but not the upside from any volume rebates.
8. The fixed and volume rebates are instead of the regulatory approach proposed in the April 2018 Consultation. This alternative regulatory approach would use regulatory depreciation (and so a RAB adjustment) to take account of any outperformance and so would spread the return of the difference between HAL's price path and the underlying revenue requirement over the longer term.
9. HAL and airlines have stated that implementation of these commercial arrangements is conditional on the CAA setting a RPI-1.5% price path and

⁴ The plan included forecasts for the iH7 period as well as forecasts for 2019.

⁵ The fixed rebate for 2020 would be paid in equal instalments over a four year period from 2021 to 2024, the fixed rebate for 2021 would be paid in equal instalments over 2022 to 2025.

retaining the existing Service Quality Rebates and Bonus (SQRB) scheme, current security expenditure levels and the methodology for calculating Other Regulated Charges (ORCs). These commercial arrangements are referred to in this consultation as the 'commercial deal' or 'commercial arrangement'.

10. An agreement on commercial terms suggests that the commercial deal may already reasonably reflect the interests of HAL and airlines. In these circumstances, our approach has focused on whether the proposed commercial deal is in the interests of consumers in accordance with our statutory duties under the Civil Aviation Act 2012 (the "CAA12"). We are also providing all airlines with the opportunity to comment on the issues raised in this consultation and whether they have any substantive objections to the commercial deal or the default arrangements put forward by HAL (for any airlines that chose not to agree to the commercial deal).

Main issues raised in this consultation

11. Chapter 1 summarises our assessment of whether the commercial deal is in the interests of consumers. This includes:
 - the long term or strategic benefits from commercial arrangements in relation to the H7 price control period and the capacity expansion programme; and
 - a comparison between the revenue that HAL is likely to generate from the commercial deal with the initial estimates made by CEPA as part of our early work on a price control for 2020 and 2021.
12. The appendices provide more detail on HAL's and CEPA's estimates of the key drivers of price control revenue, including passenger demand, operating costs and non-aeronautical revenues.
13. Our initial conclusions are that the commercial deal negotiated by HAL and the airlines at Heathrow is in the interests of consumers. In particular, encouraging the development of commercial arrangements between HAL and airlines provides longer-term advantages in terms of the possibility of better arrangements for managing the passenger traffic risks and will allow stakeholders to focus in the short-term on the challenges of capacity expansion. These factors appear to outweigh shorter term concerns around the form of the commercial deal (rebates rather than a RAB adjustment) and about the stringency for HAL of the targets associated with the commercial deal. We are therefore minded to support the iH7 commercial deal and in due course intend to bring forward changes to HAL's licence such that its price control conditions are consistent with the outcome of the commercial deal.
14. As noted above the commercial deal and iH7 price control currently applies to 2020 and 2021. If the capacity expansion programme were to be significantly delayed this could mean that it would not be appropriate for the main H7 price

control to start until 2023. Therefore, we retain the option of putting in place an arrangement to cover 2022, which would involve resetting more of the key drivers of price control revenue, including the possible reassessment of the cost of capital.⁶

Next steps

15. The iH7 review, including modifying HAL's licence, will need to be complete by the end of 2019. To deliver this, the key dates are:
 - a final decision on whether the commercial deal is in the interests of consumers, and a statutory consultation on proposed modifications to HAL's licence in July 2019; and
 - a final decision on the licence modification in November 2019.
16. If it becomes more likely that a third year of interim arrangements would be appropriate, we would aim to consult on these matters either towards the end of 2020 or early in 2021. Our view on whether this consultation would be necessary would depend on whether the overall capacity expansion programme remains on track, and the progress made by HAL on its masterplan for expansion and the DCO process during 2019 and 2020.

Our duties

17. In developing this consultation, we have had regard to our statutory duties under CAA12, which are set out more fully in Appendix A.

Views invited

18. Views are invited on any of the issues raised in this consultation and on whether:
 - stakeholders agree with our initial conclusions that on balance the commercial deal for the iH7 price control period is in the interests of consumers;
 - we should take any other steps to protect the interests of consumers over the period 2020 and 2021; and
 - there are any disadvantages with the commercial arrangements that we have not identified in this consultation.

⁶ See Paragraph 5.35 in the April 2018 Consultation. www.caa.co.uk/CAP1658

Chapter 1

Assessment of the commercial arrangement

Introduction

- 1.1 This chapter summarises our assessment of whether the commercial deal is in the interests of consumers. It includes:
- a description of the commercial deal;
 - an assessment of the wider strategic benefits of the development of more commercial arrangements at Heathrow airport;
 - a discussion of the initial work completed by CEPA on key revenue drivers for 2020 and 2021;
 - a discussion of service quality;
 - a description of our approach to setting the next main price control and the steps we will take to ensure that the rebates associated with the commercial deal do not cause any undue distortions to this process; and
 - an overall assessment and conclusions.

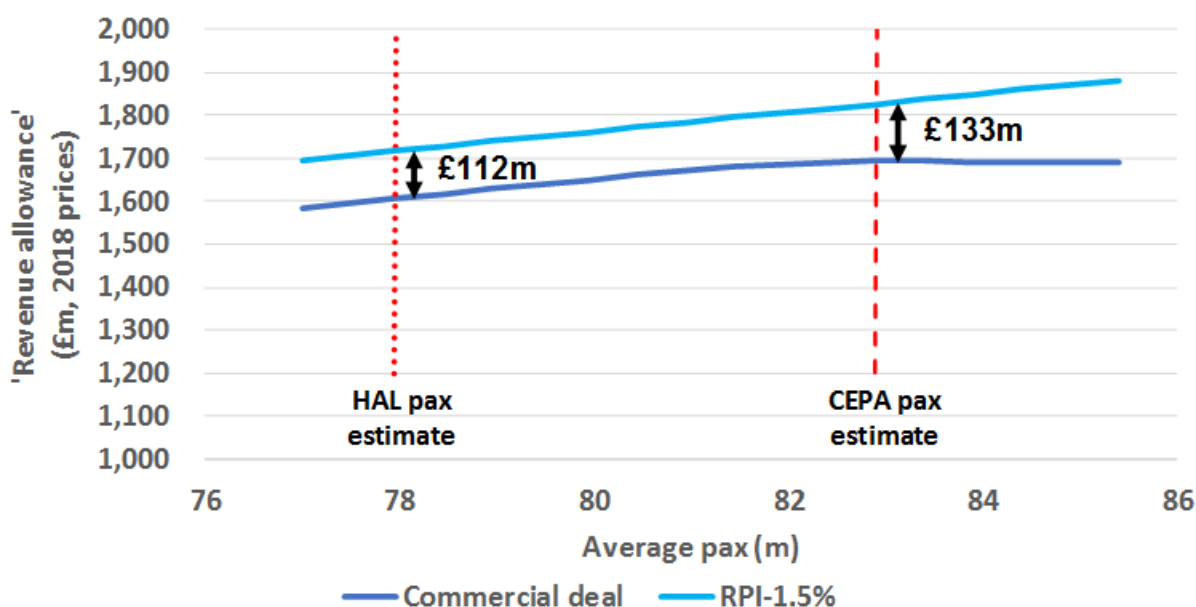
The commercial deal

- 1.2 The commercial deal uses the same “headline price path” that we proposed for the iH7 price control in our April 2018 Consultation (i.e. HAL’s per passenger revenue from airport charges changing each year by RPI-1.5%). While we had suggested a reduction in HAL’s RAB to take account of the ‘gap’ between the price path and the lower expected levels of the key underlying revenue drivers, the commercial deal uses a combination of fixed and volume rebates.
- 1.3 The commercial deal means that airlines are likely to gain in the short term as they effectively pay a lower price than a ‘headline’ price path based on RPI-1.5%, but charges to airlines may be higher than they would otherwise have been in the longer-term. Much of the existing regulatory framework, for example around capex governance, RAB and capacity expansion, is unaffected by the commercial deal.
- 1.4 Figure 1.1 shows how the lower revenue allowance under the commercial deal could compare to the headline price path. The volume rebates included in the

commercial deal have the effect of further increasing the rebate to airlines to the extent that higher passenger volumes exceed specified thresholds.⁷

- 1.5 Under HAL's forecast of an average of 78 million passengers in 2020 and in 2021, the commercial deal delivers charges to airlines (after the rebates have been applied) that are on average £112 million per annum (in 2018 prices) lower than the headline price path.⁸ If the higher passenger forecasts assumed by CEPA turn out to be correct, then under the commercial deal HAL's underlying revenue requirement would be £133 million lower than the headline price path.

Figure 1.1: Comparison of the commercial deal with the RPI-1.5% price path



- 1.6 The commercial deal provides for rebates to airlines to be made during the 2021 to 2025 period, rather than our proposed approach of spreading the difference between the underlying revenue requirement and the price path over a longer period through an adjustment to HAL's RAB. This represents significantly lower prices for HAL's customers in the shorter term.

⁷ We understand that this arrangement would only apply for airlines who have signed up to the commercial arrangement with HAL. Other airlines would still benefit from the fixed rebate but not any benefit from the volume-risk sharing rebate.

⁸ Note that this figure represents average passenger numbers across the two years. Likewise, for the CEPA passenger estimate.

- 1.7 The volume rebate mechanism included in the commercial deal provides some additional benefit to airlines from passenger growth, while giving some protection to HAL if passenger volumes decrease in 2020 and/or 2021.
- 1.8 HAL and the airlines have stated that implementation of the commercial deal is conditional on the CAA retaining some existing price adjustment mechanisms including those for capital and security expenditure and aeronautical yield, along with the SQRB scheme. Any capital expenditure adjustments and regulatory depreciation would be based on the baseline capital expenditure assumptions as set out in CAP 1658.⁹

Wider benefits from commercial arrangements

- 1.9 We have long supported the principle of airports and airlines using commercial arrangements, noting that such arrangements have the potential to facilitate better outcomes for passengers including reduced prices, improved service quality and the development of new services.¹⁰
- 1.10 We noted in the October 2018 Consultation that there could be several advantages to a commercial deal between HAL and airlines.¹¹ The benefits for consumers could extend beyond the immediate iH7 period to future price controls. Specifically, deals relating to capacity expansion could be vital to support traffic growth and the overall affordability and financeability of new capacity development at Heathrow.
- 1.11 For example, substantial benefits could be realised from:
- stakeholders working successfully together on the design, scope and cost of the capacity expansion programme;
 - a more focused and targeted sharing of volume risks than the existing price control; and
 - HAL and airlines working together more successfully to improve the passenger experience.
- 1.12 The agreement of the commercial deal is the first of its kind at Heathrow and demonstrates that HAL and airlines can work successfully together. It would also demonstrate that the regulatory framework can be flexible to accommodate such

⁹ CAP 1658. Appendix D Table D.4. www.caa.co.uk/CAP1658

¹⁰ Economic regulation of new runway capacity - CAP 1279 (March 2015), Paragraph 2.12
www.caa.co.uk/CAP1279

¹¹ Economic regulation of capacity expansion at Heathrow: policy update and consultation (October 2018), Paragraph 1.10. www.caa.co.uk/CAP1722